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UNCLAS SECTION 01 OF 05 HANOI 003385

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SUBJECT: VIETNAM'S FISCAL POLICY: STILL MUCH ROOM FOR  
IMPROVEMENT

11. (U) Summary: After two years of implementation, it is clear that the 2002 "Law on State Budget," which came into effect on January 1, 2005, has significantly improved Vietnam's budgetary fiscal transparency. Other new laws and regulations have helped modernize Vietnam's revenue collection and expenditure policies, especially with regard to corporate taxation, trade tariffs and fiscal decentralization. At the same time, the Government of Vietnam's (GVN) USD 406 million subsidy of gasoline and petroleum products in the first six months of this year has had a detrimental effect on the budget balances. At present, the GVN is focusing its spending on infrastructure improvements, social services, science and technology development, and poverty reduction. Vietnam has only a slight budget deficit, but extra-budgetary financing for GVN-sponsored development projects and State-owned enterprises (SOEs) is a growing cause for concern among foreign investors and the donor community. End Summary.

#### BUDGETARY FISCAL TRANSPARENCY

12. (U) Recent steps towards improved fiscal transparency have led to more thorough public disclosure of Vietnam's national budget. The new "Law on the State Budget," which took effect on January 1, 2004, requires budget settlements to be published within 18 months and budget estimates within 60 days of approval. The Law also requires, for the first time, a public release of total expenditures by the Ministries of National Defense and of Public Security. The GVN has previously published State Budget Final Accounts (for the fiscal year two years prior to the year of publication) and the annual State Budget Plan since 2002. The GVN's fiscal year is the same as the calendar year.

#### REVENUES

13. (U) Revenue totals constituted about 21-22 percent of Vietnam's gross domestic product (GDP) in 2004 (total revenue was VND 196,787 billion or USD 12.4 billion), a relatively small amount for a nation of 83 million people. Compared to per capita income in Cambodia (USD 320 in 2004), Thailand (USD 2600 in 2004), and the Philippines (USD 1000 in 2004), Vietnam's USD 550 per capita (USD 550 is the World Bank's 2004 number for Vietnam; the GVN estimates per capita will rise to USD 640 when year-end numbers are calculated for 2005) is rather low. Around 95 percent of the GVN's revenue comes from taxes (including import/export duties). In recent years, the most significant change to budget policy-making has been the new "uniform tax policy," which Ministry of Finance (MOF) officials say has created a "level playing field" for all categories of industrial and commercial entities, regardless of their ownership models.

14. (U) The GVN professes to have made a serious commitment to reducing the public tax burden, and they have made some progress in this area. Since the 2002-2003 fiscal year, the GVN has nearly eliminated its taxes on agricultural land and reduced and simplified the corporate income tax (CIT). The GVN now levies a flat 28 percent tax on all corporate income. The previous tax system involved several different levels that usually resulted in a tax rate of around 32 percent, depending on a company's subsidies and preferences. In addition to introducing the flat tax, the GVN also recently eliminated the 20 percent value-added tax (VAT), leaving the VAT at only five to ten percent.

15. (U) This expansionary fiscal policy has already proven its worth. The new tax policies have encouraged investment, so that even though tax rates have decreased, revenues have been remained relatively stable. During the 2001-2005 period, budget revenues increased by 16 percent annually, a higher rate than the seven percent average annual increase in GDP.

16. (U) The GVN has also reduced import and export tariffs as part of its commitment to international economic

integration, particularly to meet the Common Effective Preferential Tariffs (CEPT) for the ASEAN Free Trade Area (AFTA) agreement. Further reductions will probably be necessary once Vietnam accedes to the World Trade Organization (WTO), although the Vietnamese are trying hard to maintain high tariffs in certain industries - automobiles, for instance - which they want to protect. The tariff reductions are certain to reduce budget revenues in the short-term. Tariffs constituted 17 percent of Vietnam's budget revenues and 23 percent of its tax revenues from 2001-2003.

17. (U) According to sources at the MOF, the GVN has spent nearly VND 6.454 trillion (about USD 406 million) subsidizing gasoline and petroleum products in the first six months of the this year. (NOTE: Year-end statistics are not yet available. End Note.) The MOF eliminated import tariffs on petroleum products on March 17 in an attempt to curb price increases in Vietnam. This subsidy, coupled with the tariff cuts, has resulted in a significant loss in GVN budget revenue. To reduce pressure on the GVN budget in a period of high world oil prices, the GVN has raised the price of gasoline and petroleum products periodically throughout the year.

#### EXPENDITURES

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18. (U) The GVN has tightened its budget expenditure objectives over the last several years and is now concentrating on a narrower set of priorities. MOF officials list those priorities as infrastructure (with particular emphasis on transport and irrigation); social services, education and culture; science and technology; and poverty reduction. Investment and development spending makes up approximately one-third of total budget expenditures. The GVN has boosted education spending twice over the last seven years, so that in 2005 more than 19 percent of total spending will go to education. By 2008, the GVN expects spending on education to reach 20 percent. Although science and technology expenditures have doubled during the last five years, MOF officials say that this increase was not part of the National Assembly's "Five-Year Plan," but was one element of a long-term development strategy. Despite spending constraints, the GVN has made significant progress in poverty reduction. In 1993, some 58 percent of Vietnamese households subsisted on incomes below the poverty line, but by 2003, the GVN reported that number to be 26 percent. (Note: According to a government-controlled newspaper, impoverished households earn less than USD 7.50 per month in rural and mountainous regions and USD 10 per month in cities. Policy makers are considering whether to raise the poverty line. End note). With regard to poverty reduction, the GVN budget targets specific preferential policy and geographical regions, allowing some room for discrimination against the minority peoples who are often the poorest but also the lowest priority for GVN poverty alleviation efforts.

#### FISCAL DECENTRALIZATION

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19. (U) A notable element in the GVN's efforts to alleviate poverty and improve fiscal management is the growing shift towards budget decentralization. The 1996 "Law on the State Budget" provided the first impetus for decentralization, and an amended "Law on the State Budget" passed in 2002 advanced the process even further. The 2002 law makes few fundamental changes to the expenditure decentralization effort, but allows far more autonomy for provincial governments to manage fiscal policy on the district and commune levels. According to the World Bank, Vietnam's expenditure structure is among some of the world's most decentralized fiscal models. Whereas sub-national governments (provinces, districts and communes) spent 26 percent of total revenues in 1992, that figure rose to 43 percent in 1998 and 48 percent in 2002.

10. (U) Vietnam faces several expenditure decentralization policy problems. Chief among them is a lack of legal clarity that has caused imbalances between the central government's expenditure assignments and the capacity of local budgets to handle those assignments. Some local governments have been handed disproportionately large spending assignments, but allocated inadequate funding to carry them out.

11. (U) In addition to these vertical budget imbalances, subnational governments are legally incapable of borrowing adequate capital. The World Bank estimates subnational debt to be 0.43 percent of 2003 GDP and considers this percentage rather low by international standards. Given that many provincial governments are responsible for building and maintaining costly infrastructure projects, it is even more impressive. Current regulations keep outstanding provincial debt below 30 percent of each locality's capital budget.

The World Bank recommends that restraints on provincial borrowing be loosened, perhaps by instituting caps on debt service spending or by regulating total debt as a percentage of subnational revenues.

¶12. (U) The 2002 "Law on State Budget" also gives considerable discretion to provincial governments to determine revenue assignments to district and commune governments. The central government claims revenues from: export and import taxes, VAT and excise taxes on imports; taxes and other revenues from the petroleum industry; and corporate income taxes on enterprises with uniform accounting. Tax revenues assigned to the subnational level include land and housing taxes, natural resource taxes excluding those on petroleum activities, license tax, taxes on transfer of land use rights, fees on land use, land rent, revenues from the leasing and sale of publicly owned dwellings, registration fees and most other fees and charges. The central and subnational governments also share taxes based on formulas unique to each province. The GVN believes that budget revenues allocated to subnational governments accounted for about 30 percent of all tax revenues at the end of 2004.

¶13. (U) Allocating revenue to local governments while avoiding internal trade barriers is a policy challenge for the GVN. The World Bank recommends granting more tax autonomy to provincial governments by allowing subnational governments to select tax rates for at least one significant source of revenue at a rate somewhere between the minimum and maximum rates stated by the National Assembly. (Note: The Vietnamese constitution stipulates that the National Assembly is charged with approving the national and consolidated subnational budgets. End note.) In addition, the World Bank recommends greater specificity for tax sharing regimes, especially with regard to the corporate income tax (CIT) and the VAT. The current tax regime tends to benefit larger cities, where CITs are actually collected and debited. The World Bank believes an equitable apportionment regime between provinces would allow more appropriate revenue distribution, such as a VAT system based on final consumption in each jurisdiction. In the case of the CIT, a regime based on the geography of the company's payroll would distribute revenue more equitably.

#### BUDGET NEARLY IN BALANCE

¶14. (U) The MOF has recently been maintaining a budget deficit of less than three percent of GDP. (Note: By law, the budget deficit cannot exceed five percent of GDP. End note.) The GVN restricts on-budget borrowing to investment expenditures. For the most part, foreign commercial borrowing and domestic bonds covered the deficit. Greater dependence on domestic borrowing over the last two years has caused interest rates to rise relative to foreign borrowing, which is comprised almost entirely of concessional loans.

¶15. (U) To look only at on budget borrowing, however, distorts the reality of Vietnam's public debt situation. Some bonds issued to finance infrastructure and education have been kept off budget, along with expenditure arrears from past transport sector infrastructure improvements. In the former case, the GVN's 2004 expenditure report says VND 5 trillion (about USD 316 million) in bonds were issued to finance infrastructure improvements (namely, the Ho Chi Minh Highway, rural road improvements and irrigation projects in the central provinces) and VND 2.5 trillion (about USD 158 million) were issued for education. While the published budget does not reflect the principal payments on these loans, interest payments will be shown on budget in the future. State-owned commercial banks (SOCBs) and insurance firms were the primary purchasers of these bonds, reflecting the continued dependence on policy lending by GVN institutions and banks. Transport sector arrears represent a growing disparity between the Ministry of Transport (MOT) and MOF's expenditure records. Specifically, MOF records show that transport spending reached 3.5 percent of GDP in 2002, whereas MOT records showed spending of about 5 percent. The problem stems from past MOT expenditure commitments that were not shown on budget. The subsequent accumulation of about VND 6.5 trillion (about USD 411 million) in arrears should be paid on budget in the future.

¶16. (U) Financed through Official Development Assistance (ODA) and loans from the Vietnam Postal and Savings Company (VPSC), the Development Assistance Fund (DAF) is yet another substantial extra-budgetary policy lending vehicle. The DAF floated VND 7-8 trillion (USD 441 - 504 million) in bonds in 2004. According to the GVN's expenditure report, the DAF's domestic capital sources amount to roughly 9 percent of annual GDP in 2004, "making it the biggest financial institution in the country." About 80 percent of the DAF's lending went to State-owned enterprises (SOEs), though the DAF also reserves the right to lend to private and joint venture firms and even to lend ODA to foreign governments.

Despite its bank-like functions, the DAF is not subject to standard banking regulations and its accounting practices, risk management and reporting standards are still very rudimentary. The DAF has to seek annual budget approval from the National Assembly. The recently issued decree 106/2004/ND-CP is a step towards regulating the DAF while maintaining the GVN's ability to continue its policy lending to GVN institutions. The decree narrows the list of eligible borrowers while establishing a more market-oriented basis for the DAF's on-lending activities by imposing new requirements on borrowers for direct repayment, collateral assets and feasible business plans. Both the World Bank and the International Monetary Fund (IMF) have expressed serious concerns about the DAF and the fact that it increases the number of poor quality loans.

#### SOE AND DEFENSE BUDGET ITEMS

17. (U) MOF officials confirmed that SOE revenues are reported on budget, but only as corporate tax revenue. Only crude oil exports from cooperative contracts with foreign firms are reported on budget. Using this accounting regime, oil-producing SOEs contributed 34 percent of CIT revenues in 2003 (which accounted for 31 percent of total tax revenues that year), according to the World Bank.

18. (U) Defense expenditures are also now shown on budget in accordance with the new Law on State Budget. However, no defense items appear on any of the published budget reports, possibly because budget projects are published 18 months after the end of a given fiscal year (the revised law only came into effect in 2004).

19. (SBU) It is also worth noting that the GVN is loosening its control on price setting for commodities. The GVN will continue to set prices for certain public services like city buses.

20. (SBU) Comment: While the GVN's fiscal policy appears healthy on paper, its persistent dependence on directed lending and extra-budgetary financing has resulted in several contingent liabilities. Greater budget transparency and SOCB restructuring will be necessary to improve the GVN's fiscal stance. Both are required as part of WTO/BTA commitments, but progress has been slow to date. Short of immediately dissolving or "equitizing" on lending and policy lending financial institutions like the DAF, such institutions should at least face the same regulatory scrutiny as chartered banks and firms. Regarding tax revenues from trade, it is difficult to predict when lowered tariffs will bolster foreign trade to the extent that they compensate for lost budget revenues. It is more likely that as the domestic economy improves due to global economic integration, the importance of trade tariffs on the budget sheet will decline. Vietnam's fiscal priorities and poverty reduction achievements are commendable. The GVN should avoid letting budget decentralization impede the central government's short and medium-term plans for fighting poverty and instituting market reforms. It should also seek similar rather than different tax regimes in each province, which could hinder domestic trade and investment. End comment.

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